

SUBJECT: Digital Arts Studio Partnership Demonstration Program Credit

Department Director	Date
S. Stanislaus	4/17/06

THIS BILL

This bill would authorize an allocated aggregate amount of \$5,000,000 (five million dollars) annually to the Commission (as defined below) that could be awarded as credits to Corporation Tax Law (CTL) taxpayers that support digital media arts. It would allow unused allocation amounts to be carried over to the following year to augment the following year's allocation amount.

The following terms are defined:

- "Program" means the Digital Arts Studio Partnership Demonstration Program.
- "Commission" means the host agency, which is yet to be named in the bill, that would certify partnerships and taxpayers.
- "Taxpayer" means an applicant who has been allocated tax credits by the commission.
- "Partnership" means the state or local non-profit organization that is certified by the commission to be the designated partner in any of the regions established by the commission to receive donations and assistance.
- "Support of the program" means only those activities and items that advance the purposes of the program, including certain specified activities and items.

This bill would deny a deduction for any amount for which a credit is allowed to avoid what would otherwise be a double tax benefit. The Commission would have the responsibility for ensuring that taxpayers awarded the credit qualify for the credit.

This bill would require the Commission to do the following:

1. Establish procedures to allocate tax credits to taxpayers on a first-come, first-served basis.
2. Determine when a taxpayer is a qualified taxpayer.
3. Issue a certificate to the taxpayer indicating the amount of credit allocated.
4. Assuring that the combined allocated credits keep within the annual cap.
5. Perform audits of the program to ensure the funds were received and used accordingly.
6. Promulgate no later than March 1, 2007, implementing regulations.

This bill would annually require the Commission to provide a list of the taxpayers that qualify for the credit to the Franchise Tax Board. Only those taxpayers that receive certification from the Commission are eligible to claim the credit.

This bill would require that on January 1, 2008, and annually thereafter, the Commission report to the Legislature on the effectiveness of the program.

This bill would only allow the credit to CTL taxpayers and any allocated credit that was unused by a taxpayer could be carried over for nine years.

This bill would become operative only if Assembly Bill 252 of the 2006-07 Regular Session is chaptered and reauthorizes the Digital Arts Studio Partnership Demonstration Program.

IMPLEMENTATION CONSIDERATIONS

It is unclear how or when a returned or disallowed allocation would impact an amount claimed by a taxpayer on its tax return.

This bill would require the commission to establish rules for reallocating amounts returned or subsequently disallowed, but the bill is silent on how an allocation would be returned or disallowed.

This bill does not identify the host agency or the commission that would be responsible for administering the credit.

If the implementations mentioned above are addressed, implementing this bill would not significantly impact the department's programs and operations.

TECHNICAL CONSIDERATIONS

This bill indicates that it would become operative only if Assembly Bill 252 of the 2006-07 Regular Session is chaptered. The current regular session is the 2005-06 session, not the 2006-07 session.

This bill states that it would only be operative if AB 252 becomes operative. AB 252, as currently drafted, would not establish the Digital Arts Studio Partnership Demonstration Program. AB 252 proposes to amend Section 8778 of the Government Code; this section was repealed on January 1, 2006. Consequently, AB 252 as currently drafted is legally defective.

This bill should address how the credit would be allocated to an S Corporation. Normally, only one-third (1/3) of the credit is allocated to an S Corporation.

LEGISLATIVE HISTORY

AB 1582 (Dymally, 2005/2006) would have allowed a tax credit to corporate taxpayers that support digital media arts. AB 1582 was similar to this bill. AB 1582 failed passage out of the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. None of these states provides a credit similar to the credit allowed by this bill.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the Corporation Tax revenue impact from this bill would be as follows:

Estimated Revenue Impact of AB 1887 Effective on January 1, 2007 Enactment Assumed After June 30,2006		
<i>Contingent on the passage of AB 252</i>		
(\$ millions)		
2006-07	2007-08	2008-09
loss	- \$5	- \$5

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

This bill enacts corporate tax credits for the support of a digital media arts studio partnership demonstration program. The program is capped at \$5 million per calendar year on a first-come, first-served basis. This estimate assumes the technical perfection, and passage, of companion legislation AB 252.

The estimate assumes that only 80%, or \$4 million, of the credit will be allocated in 2007. The remainder of the first year credit will be carried over and allocated in the second year. It is also assumed that taxpayers would only be able to use 80 percent of the credit that is granted. Therefore the credit usage for 2007 would be \$3.2 million (\$4 million X 80 %).

There will also be an offset to this revenue loss because taxpayers that claim the credit will lose the ability to claim the corresponding deduction that they would be claiming in the absence of this credit. The estimate assumes that 30 percent of the qualifying expenditures will be for depreciable property. For depreciable property, it is assumed that the credit would be taken in lieu of 3 year straight-line depreciation. For the expenses other than those related to depreciable property, the loss of deductions would be equal to the amount of credit claimed. The tax offset would be equal to the sum of lost depreciation deductions and the lost other deductions times the appropriate marginal tax rate. The total amount of the deduction offset was estimated to be \$3.2 million (\$4 million X 30 % X 1/3rd + \$4 million X 70 %).

The appropriate marginal tax rate depends on the marginal tax rates for the affected taxpayers. It was assumed that 20 percent of credit would be claimed by S corporations and have an effective tax rate of 1.5 percent. The remainder would have a marginal tax rate of 8.84 percent. The average marginal tax rate would, therefore, be 7.37 percent (1.5 % x 0.2 + 8.84% x 0.8). The total amount of the offset for 2007 would be, therefore, \$0.2 million (7.37% X \$3.2 million).

The net impact of the bill for 2007 would be \$3 million, or the net of the \$3.2 million credit and the \$0.2 million offset. This estimate assumes that, as the bill is currently drafted, none of the credits claimed by S-corporations can be passed through to the owners. The results presented in the table above are adjusted to reflect fiscal year estimates.

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